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BOARD OF EQUALIZATION

STATE OF CALIFORNIA

In the Consolidated Matter of the Appeals of:	**REHEARING SUMMARY**
	PERSONAL INCOME TAX APPEAL
RICHARD A. HALL	Case No. 533898

Year	Proposed Assessments
2003	$157,185

Representing the Parties:

For Appellant:	A. Lavar Taylor, Esq. Lisa O. Barnett, Esq.
For Franchise Tax Board:	Leah Thyberg, Tax Counsel

QUESTION: Whether appellant has established that a $1,476,000 distribution to appellant from appellant's partnership was a bona fide loan.

REHEARING SUMMARY[1]

Background

Prior Hearing

The Board previously heard this matter at the original hearing on February 26, 2013 and

[1] This appeal is before the Board as a rehearing. The background facts contained herein are as provided by the parties for the original hearing.

determined that appellant failed to show that the disputed $1,476,000 payment by appellant's partnership was a bona fide loan rather than a taxable distribution and, therefore, appellant did not demonstrate error in respondent's proposed assessment. Appellant filed a Petition for Rehearing (PFR) in which he restated his argument that an application of the factors developed by case law supports a finding that the arrangement constituted a bona fide loan. Therefore, appellant concludes that the Board committed an error of law by denying the appeal.

Factual Background

Appellant is a general partner owning a 45 percent profits and capital interest in Richard Hall, LP (RHLP), a limited partnership that owned the Copacabana Mobilehome Park (Copacabana property) in La Verne, California. The other two partners are David E. Rose with a 5 percent interest and Robert K. Ostengaard with a 50 percent interest. In April 2003, RHLP sold the Copacabana property under threat of condemnation for $8,000,000. (App. Op. Br., pp. 2-3; Resp. Op. Br., p. 1.)

The net proceeds from the sale were $3,278,248. The 2003 partnership return of RHLP reported $3,681,000 as distributions to the partners and appellant's 2003 Schedule K-1 reported $1,668,500 in distributions received. Appellant executed a document titled "Demand Promissory Note" (Note) dated April 16, 2003 reciting that he promises to pay upon demand the principal sum of $1,476,000 to RHLP and that RHLP intends to reinvest the proceeds in a replacement property under the provisions of Internal Revenue Code (IRC) section 1033. Unless previously demanded, the Note further provides that appellant is obligated to pay the principal amount of the Note at least two business days prior to the date RHLP reinvests the proceeds to acquire the replacement property. The Note did not provide for the accrual and payment of interest on the principal unless the total amount was not paid when due; in that event, appellant agreed to pay interest on the delinquent portion which was presumed to be the amount of damages for the late payment. The initial due date for the reinvestment was December 31, 2006, but RHLP requested and was granted extensions by the Internal Revenue Service (IRS) until December 31, 2010. (App. Op. Br., p. 3 and attachments; Resp. Op. Br., pp. 1-2.)

On April 13, 2007, respondent notified appellant that the 2003 partnership return of RHLP had been selected for examination. On June 20, 2007, RHLP filed its 2006 partnership return and appellant's Schedule K-1 included a note stating that "[i]ncluded in current year capital is a prior period adjustment in the amount of $1,476,000. This amount was previously reported as a debit to the partner's capital account. This was an error as the amount will be repaid by the partner. The amount has been correctly restated as an advance to the partner." Respondent issued a Notice of Proposed Assessment (NPA) dated February 3, 2009, which assessed additional tax on the amount transferred to appellant in excess of appellant's tax basis in RHLP. Appellant filed a timely protest of the NPA and respondent affirmed the NPA in a Notice of Action dated April 28, 2010. Appellant then filed a timely appeal. (App. Op. Br., p. 2.)

<u>Contentions</u>

<u>Appellant's Rehearing Contentions</u>

Appellant states that on its timely filed 2003 federal Form 565 (partnership) return RHLP made an election under Internal Revenue Code section 1033 to defer taxation of the gain from the sale of the Copacabana property by reinvesting the gain in like-kind property. Appellant states that the initial deadline to execute the exchange was December 31, 2006, but RHLP requested several extensions of time to acquire a replacement property and the final deadline was December 31, 2010. Appellant further states that RHLP acquired two replacement properties in late 2010 and appellant provided the IRS in February 2011 with information confirming the acquisitions. Appellant states that the acquisitions were reported on RHLP's 2010 federal partnership return. (App. RHG Br., pp. 3-4.)

After the sale of the Copacabana property, appellant states that payments were made to the partners of RHLP out of the proceeds of the sale. Appellant further states that RHLP formalized the loan amounts and terms in promissory notes and the partners were aware of the IRC section 1033 and California law requirements concerning the deferral of tax on the gain. Appellant asserts that the partners agreed that RHLP should reinvest the proceeds once suitable replacement property was identified and that the loans would be repaid when RHLP was prepared to acquire such property. Appellant further asserts that the partners understood that the loans were to be repaid no later than the expiration of the time period for acquiring replacement property under IRC section 1033. Appellant states the terms of the promissory notes as follows:

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- Written unconditional obligation to pay on demand or at a reasonably close fixed maturity date;
- Existence of a sum certain;
- Definite date of repayment;
- Loan was repayable regardless of the debtor's income or lack of income;
- No fixed interest rate percentage which was appropriate under the circumstances;
- A default rate of interest of 10 percent per annum for late payment and costs of collection.

Appellant states that the loans were incorrectly characterized as distributions on the RHLP balance sheet and incorrectly reported as distributions on the Schedules K-1 as described by RHLP's certified public accountant (CPA). Appellant states that the mistake was corrected on the original 2007 RHLP tax return[2] which accurately reflects the amounts paid as an advance to the partners. (App. RHG Br., pp. 5-6.)

Appellant asserts that the partners repaid the loans pursuant to the terms of the promissory notes at least 2 days before the acquisition of the replacement properties. In addition to repayment, appellant also states that the partners made capital contributions and the last payment of each partner was made on or before December 9, 2010, and all payments were deposited into RHLP's operating bank account. Appellant states that he was a high net worth individual at the time of the loan with a net worth of $25,124,076 as of April 30, 2003. Appellant asserts that to his knowledge there is no case law that permits a taxing authority to recharacterize a loan as an equity distribution when the parties intended a loan, the parties executed a contemporaneous promissory note, and the borrower had the ability to repay the loan, had an independent motive to repay the loan timely, and timely repaid the loan. (App. RHG Br., pp. 7-8.)

Appellant recites eleven factors that appellant asserts the Ninth Circuit Court of Appeals has articulated in determining whether amounts paid constitute "equity capital or indebtedness" as follows:

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[2] The record shows that it was reported on RHLP's 2006 partnership return.

1. Names given to the certificates evidencing the indebtedness
2. Presence or absence of a maturity date
3. Source of repayment
4. Right to enforce payment of principal and interest
5. Participation in management
6. Status equal to or inferior to that of regular corporate creditors
7. Intent of the parties
8. Thin or adequate capitalization
9. Identity of interest between creditor and stockholder
10. Payment of interest only out of dividend money
11. Ability of the corporation to obtain loans from outside lending institutions

Appellant states that the court has held that no single factor is decisive and that "there is no general requirement that transactions be entered into in a conventional way for them to be recognized as having the usual tax result." (App. RHG Br., pp. 9-10.)

Appellant makes the following arguments in support of his position that each of the factors favors treating the payment as a loan:

1. The certificates evidencing the indebtedness were called promissory notes and were executed at the time the payments were made and bound the partners to an unconditional repayment obligation.
2. In *Indmar Products, Inc. v. Comm'r* (6th Cir. 2006) 444 F.3d 771, the Sixth Circuit Court of Appeals acknowledged that the presence or absence of a maturity date and a fixed obligation to repay "carries little weight in the final analysis" and placing any significant weight on this factor would "create a virtual per se rule against the use of demand notes by stockholders . . ." In *Piedmont Mineral Co. v. U.S.* (4th Cir. 1970) 429 F.2d 560, the Fourth Circuit Court of Appeals also held that while this factor is a relevant consideration, it is "far from controlling" and "the maturity of a demand note is determinable by its holder." Here, appellant did not hold a controlling interest in RHLP and, thus, RHLP could have demanded repayment at any time over appellant's objection.

   The Ninth Circuit in *Hardman v. U.S.* (9th Cir. 1987) 827 F.2d 1409, in determining that a transaction was a sale rather than a capital contribution held that, although the shareholder's

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agreement with the corporation to share profits from the sale of real property did not include a fixed maturity date, the repayment was tied to a fairly certain event, i.e., the sale of the property. The U.S. Tax Court held that a court must ascertain "whether the lack of a fixed maturity date is explainable or otherwise negated by other evidence in the record." Here, the promissory note did not have a specific date for repayment but had a fixed maturity date of at least two days prior to reinvestment notwithstanding the extensions of the deadline for acquisition of the replacement property. (App. RHG Br., pp. 10-12.)

3. Repayment dependent upon corporate earnings indicates equity but in this case repayment was not dependent upon RHLP's earnings and both RHLP and appellant had high expectations of repayment. (App. RHG Br., pp. 12-13.)

4. A definite obligation to enforce repayment is evidence of debt and the absence of security generally points to equity. However, in *American Underwriters v. Comm'r*, T.C. Memo 1996-548, the court found that the creditor could enforce the debtor's repayment of advances, but not the payment of interest, and the creditor did not require security for the advances. However, because the creditor and debtor were commonly owned and the debtor had a history of timely repayment, the court held that the absence of security did not preclude the existence of a loan.

Similarly, RHLP could have enforced appellant's repayment at any time, thus, the absence of security is not significant. The terms of the promissory notes ensured that RHLP would be timely repaid to acquire the replacement property. In addition, appellant had an incentive to repay the loan because if the loan was not timely repaid, RHLP would have to recognize and pay tax on the gain from the sale of the Copacabana property. For that reason, the other partners would likely have brought suit to enforce repayment if appellant had not complied with the terms of the promissory note. The promissory note is recourse and has no limitations on collection efforts and appellant was a high net worth individual so RHLP could collect any amounts due if necessary. (App. RHG Br., pp. 13-15.)

5. If a shareholder's percentage interest in the entity or voting rights increases as a result of the transfer, it will indicate the transfer was a contribution to capital rather than a sale. Here, appellant's partnership interest did not change as a result of the transfer which is further evidence of a loan.

(App. RHG Br., p. 15.)

6. The parties intended the amounts paid to be loans to the partners. In *Hardman, supra*, the court described the purpose of the inquiry as discerning the parties' intent and the court looked to the objective evidence which the court found favored the taxpayers' position that the transaction was a sale rather than a capital contribution. In *American Underwriters,* the court asked four questions to evaluate the parties' intent aimed at determining whether the transaction reflected the economic reality of a creditor-debtor relationship and whether there was a reasonable expectation of repayment. Here, the parties' intent to make a loan is evidenced by the contemporaneous documentation which was prepared more than a year before the filing of the 2003 return that incorrectly characterized the payment as a distribution. The CPA has stated that the return was prepared incorrectly, the partners have submitted affidavits stating that they intended RHLP to make a loan and all the amounts were repaid. Moreover, there was a reasonable expectation of repayment based on appellant's high net worth and a strong independent motive to repay in view of the potential tax liability otherwise. (App. RHG Br., pp. 15-17.)
7. Thin capitalization evidences a capital contribution but this factor is inapplicable because it applies to loans from shareholder to a corporation rather than from a partnership to its partners. Nonetheless, RHLP was adequately capitalized with the proceeds from the sale of the Copacabana property and, later, with the promissory notes. (App. RHG Br., pp. 17-18.)
8. A fixed interest rate and interest payments indicates debt while no interest payment indicates equity. However, the court's analysis in *American Underwriters*, *supra* shows that a "valid explanation" as to why interest was not paid demonstrates that the absence of an interest term is not a controlling factor. Here, interest was to be paid in the event of default but was not a condition of timely repayment because it would have flowed to RHLP and back to the partners. Thus, the absence of interest on the loan should not be a "material factor". (App. RHG Br., pp. 18-19.)

<u>Respondent's Contentions</u>

Respondent notes that appellant acts both as a debtor and, as a partner in RHLP, as a creditor which heightens the level of scrutiny because appellant and the other partners can mold the transaction at their will so that it appears to be a loan when it effectively acts as a distribution. For that reason, respondent contends that under such circumstances courts focus on the substance rather than the form of a transaction. Respondent asserts that the form of a transaction includes self-serving declarations of intent and "corporate paper encrusted with the appropriate nomenclatural captions." The substance of a transaction, according to respondent, is whether the creditor-debtor relationship "can stand on its own feet" which demonstrates" the true intent of the parties, as objectively indicated by their actions." Respondent contends that appellant has failed to establish a bona fide loan because the circumstances show the transaction was not at arm's-length. (Resp. RHG Br., pp. 3-4.)

Respondent contends that RHLP did not act as a true creditor which would typically ensure repayment of a loan by requiring security or evidence of the debtor's financial status and enforcing repayment upon default. Respondent adds that a creditor may also ensure repayment by requiring a fixed maturity date and repayment schedule but that the promissory notes did not include those provisions. Respondent asserts that the repayment schedule is indicative of a loan because it provides certainty that a loan will be repaid whereas a provision for repayment in full increases the risk of nonpayment because the debtor has "no structure or responsibility to ensure the ability to repay the full amount by the maturity date." Respondent further asserts that the provision for the maturity date stated as "on demand" or two days before reinvestment did not constitute a fixed maturity date because the reinvestment date was extended each year for four years, "creating an inordinate period." Respondent also asserts that the maturity date was not fixed because repayment was contingent a reinvestment plan which acted as "a condition that continuously suspends the obligation to repay because the plan was extended for four years." (Resp. RHG Br., pp. 3-6.)

Respondent asserts that the absence of a security requirement indicates that the payment was a distribution because a true creditor would ensure repayment by this means. Respondent contends that *America Underwriters, supra* cited by appellant is distinguishable, even though appellant and RHLP are "commonly owned", because there is no evidence of a history of timely and expeditious repayment. Therefore, respondent concludes the absence of a security requirement indicates a distribution. Respondent asserts that RHLP did not require evidence of appellant's financial status before transferring the $1,476,000 to him and his list of assets and liabilities showed that in 2003 he had only $644,029 in cash, which was his only liquid asset. For those reasons, respondent contends this factor indicates a distribution because RHLP did not require such evidence and appellant did not have the liquidity to repay the amount "on demand" or within two days of reinvestment. Furthermore, when a debtor can become the same entity as the creditor, respondent asserts that the debtor "can then mold a taxable distribution to a tax-free loan while also holding sole authority to enforce repayment against himself." Because the partners make up RHLP, respondent contends that no partner would enforce repayment against the others because each partner benefited by receiving a tax-free distribution. (Resp. RHG Br., pp. 6-8.)

Respondent states that the name of the document as a promissory note was only a label and the substantive focus is "on whether the partners truly treated themselves as strangers through their objective actions and not whether the promissory note says a loan was made." Respondent contends that appellant disregarded the terms of the promissory note by failing to repay the full amount in a single payment two days before reinvestment in the replacement property which indicates the payments were a contribution to RHLP and, consequently, the original payment to appellant was a distribution. (Resp. RHG Br., pp. 8-9.)

Respondent maintains that the parties' intent cannot be determined by the parties' own statements and description of the transaction in the affidavit, the IRC section 1033 election on the 2003 return or the promissory note. In view of appellant's focus on such indicia of subjective intent, respondent notes that the payments were reported as distributions on the 2003 partnership return, that appellant attempted to "correct" the "error" by stating that it was a loan on the 2006 partnership return but never filed an amended 2003 partnership return. Respondent contends that true intent is determined by evaluating objective actions, such as the parties' disregard of the promissory note terms, or RHLP's failure to ensure repayment by requiring security, evidence of financial ability to repay, a repayment schedule, a fixed maturity date and payment of interest. Respondent also argues that the fact that money was needed to complete the IRC section 1033 transaction does not indicate the repayment of the alleged loan was intended as those funds could be obtained from any source, as evidenced by the partners' contributions in 2010. (Resp. RHG Br., pp. 8-10.)

Respondent further argues that the absence of a fixed interest rate and regular interest payments indicates the payments were distributions as a true creditor requires interest which is compensation for the use of money. Because a true creditor receives compensation for lending money, the lack of compensation indicates that a debtor-creditor relationship did not exist and the payment was distribution rather than a loan. Respondent also asserts that if RHLP intended to treat the payment as a loan it would have reported imputed interest during the term of the loan until the purported repayment. In this regard, respondent states that IRC section 7872 requires imputed interest to be reported at the Adjusted Federal Rate for below market loans, which includes loans that charge no regular interest payments. RHLP's failure to report imputed interest indicates that the payment was a distribution rather than a loan. Respondent adds that the failure to require regular interest payments has tax significance because such interest payments on a personal loan would not be deductible. Thus, respondent contends that appellant received a tax benefit by failing to pay nondeductible interest on the alleged loan. (Resp. RHG Br., pp. 10-11.)

Finally, respondent contends that the amount of the payments from the proceeds of the sale was proportionate to each of the partners' interests in RHLP. Respondent asserts that true creditors will disregard any underlying relationship because their sole intention for making a loan is repayment. Moreover, respondent asserts that an underlying relationship is recognized when the payment is proportionate to the ownership interest because the payment acts as a distribution to a partner rather than a loan to a debtor. Thus, respondent contends that this factor indicates a loan because the payment was proportionate to appellant's 45 percent interest in RHLP. (Resp. RHG Br., pp. 11-12.)

<u>Appellant's Reply on Rehearing</u>

With respect to respondent's argument that there was no repayment schedule or maturity date, appellant argues that the loan was payable on demand and appellant had a minority interest in RHLP, thus the other partners could have demanded repayment at any time. Appellant contends that these two conditions were "less favorable" than a fixed repayment schedule which would have prevented the other partners from calling the loan due at any time. Appellant also argues that respondent ignores the fixed deadline for repayment two days before the reinvestment date which is readily ascertainable as the statutory deadline set by IRC section 1033, regardless of the fact that the IRS allowed extensions. Appellant states that neither he nor RHLP had the ability to unilaterally extend the fixed deadline for acquisition which determined the fixed date for repayment. (App. RHG Reply Br., pp. 2-3.)

Appellant states that courts have recognized that the issuance of a note payable on demand by a closely held business entity does not indicate that the note is not evidence of a bona fide loan. Appellant repeats its argument that the Sixth Circuit Court of Appeals in *Indmar Products, Inc., supra*, held that the presence or absence of a maturity date and a fixed obligation to repay "carries little weight in the final analysis" and placing any significant weight on this factor would "create a virtual per se rule against the use of demand notes by stockholders . . ."; that the Fourth Circuit Court of Appeals in *Piedmont Mineral Co., supra*, held that while this factor is a relevant consideration, it is "far from controlling" and "the maturity of demand note is determinable by its holder"; that the Ninth Circuit in *Hardman, supra* held that a fixed maturity date could be determined when the repayment was tied to a fairly certain event, i.e., the sale of the property; and that the U.S. Tax Court held that a court must ascertain "whether the lack of a fixed maturity date is explainable or otherwise negated by other evidence in the record." (App. RHG Reply Br., pp. 3-4.)

Appellant contends that the evidence strongly supports the conclusion that repayment was not within appellant's control, the maturity date was tied to the deadline for acquisition of the replacement property, and the other partners had the ability to call the note due at any time, over appellant's objections because he was a minority partner. Appellant also contends that the CPA has explained that the tax return erroneously reflected that the payment was not treated as a loan. Finally, appellant contends that all the partners understood the payments to be loans as evidenced by the contemporaneous promissory notes and repayment by the deadline. (App. RHG Reply Br., pp. 5-6.)

Appellant disputes respondent's contention that there was no security for the loan by pointing out the adverse tax and legal consequences that would have resulted if the loan was not timely repaid. Appellant further argues that the effect of these adverse consequences "reinforces the fact that there was a fixed date for repayment of the loan." Specifically, the statutory deadline for acquiring a replacement property is a fixed and determinable date and the repayment date was tied to that deadline. Appellant also dismisses respondent's point that RHLP did not require confirmation of appellant's financial ability to make repayment stating that appellant's net worth was much larger than the payment amount and appellant actually made timely repayment. Finally, appellant states that respondent appears to argue that the document evidencing the debt was not a promissory note. Appellant maintains that the best evidence of a loan is the fact that appellant repaid the amount on time which also demonstrates an objective intent to make a loan. (App. RHG Reply Br., pp. 6-7.)

<u>Applicable Law</u>

It is well-settled that a presumption of correctness attends respondent's determinations as to issues of fact and a taxpayer has the burden of proving error in such determinations. (*Appeal of Oscar D. and Agatha E. Seltzer*, 80-SBE-154, Nov. 18, 1980.) This presumption is a rebuttable one and will support a finding only in the absence of sufficient evidence to the contrary. (*Id.*) A taxpayer's unsupported assertions are not sufficient to satisfy his burden of proof. (*Appeal of James C. and Monablanche A. Walshe*, 75-SBE-073, Oct. 20, 1975.)

A transfer of money is a loan for federal income tax purposes if, at the time the funds were transferred, the transferee unconditionally intended to repay the money, and the transferor unconditionally intended to secure repayment. (*Jones v. Comm'r*, T.C. Memo 1997-400.) With respect to a transfer from a corporation to a shareholder, "[m]ere declarations by the parties that they intend a certain transaction to constitute a loan [are] insufficient if [they] fail[] to meet more reliable indicia of debt which indicate the 'intrinsic economic nature of the transaction.'" (*Alterman Foods, Inc. v. U.S.* (5th Cir.1979) 505 F.2d 873, 877.)

In determining whether such a transfer to a shareholder should be treated as a loan, the courts have considered eleven factors (restated below) as relevant in analyzing the transfer. (*Jones v. Comm'r*, *supra*; see also *Alterman Foods, Inc. v. U.S.*, *supra*.) The various factors are not of equal significance and no single factor is controlling. (*Alterman Foods, Inc. v. U.S.*, *supra* at 877.)

1. *The extent to which the shareholder controls the corporation*
2. *The earnings and dividend history of the corporation*
3. *The magnitude of the withdrawal and whether a ceiling existed to limit the amount advanced*
4. *How the corporation recorded the withdrawals on its books and records*
5. *Whether the shareholder executed a promissory note*
6. *Whether interest was paid or accrued*
7. *Whether the corporation ever undertook to compel repayment*

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8. Whether there was a fixed maturity date

9. *Whether security was given for the loan*

10. Whether the shareholder was in a financial position to repay

11. Whether there was any indication the shareholder attempted to repay

In *Indmar*, *supra* the stockholders started advancing funds to their corporation in the 1970s and received a 10 percent annual return in exchange. The corporation treated all of the advances as loans from stockholders in the corporate books and records, made monthly payments calculated at 10 percent of the advanced funds and reported the payments as interest expense deductions on its federal income tax returns. Consistent with the corporation's reporting, the shareholders reported the payments as interest income on their individual income tax returns. Beginning in 1993, the parties executed notes for the advances which notes were payable on demand and freely transferable, had no maturity date or monthly payment schedule, and had a fixed interest rate of 10 percent. In 1998, when the outstanding transfers totaled $1,222,133, the corporation executed two line of credit agreements with the stockholders for $1 million and $750,000, respectively, which provided that the balances were payable on demand and the notes were freely transferable. The agreements provided for a 10 percent interest rate and had no maturity date or monthly payment schedule. Finally, none of the advances was secured.

In its application of the factors, the court found that the fixed rate of interest and regular interest payments set forth in the executed notes indicated that the advances were bona fide loans. With respect to the absence of a fixed maturity date and a fixed obligation to repay, the court found that this factor carried little weight because the parties structured the advances as demand loans, which had "ascertainable" maturity dates. In addition, the court found that the shareholders' temporary waiver of payment did not convert the debt into equity because they still expected that they would be repaid. The court concluded that "[t]o give any significant weight to this factor would create a virtual *per se* rule against the use of demand notes by stockholders, even though '[m]uch commercial debt is evidenced by demand notes.'"[citation omitted].

In *Hardman*, *supra* the taxpayers, a married couple, together owned an 89 percent interest in a corporation, with 25 percent of the corporation owned by the wife and 64 percent of the corporation owned by the husband. Taxpayer-wife purchased a 100 acre tract of undeveloped land, made a down payment and executed a secured promissory note for the remainder of the purchase price. She made three payments on the note but was unable to continue making payments, so she conveyed the property to the corporation which reimbursed her for the payments and the down payment, assumed the promissory note, and executed an agreement whereby the corporation, in consideration of the sale of the property, agreed to pay her one-third of any net profit that the corporation derived from the property. The corporation later sold the property and paid taxpayer-wife one-third of the net profit which the taxpayers reported as gain from the sale of real property and took a "corresponding" capital gains deduction. The corporation added the payment to its basis in the property and calculated its capital gains accordingly.

The district court concluded that the transaction was a capital contribution to the corporation by taxpayer-wife and that the payment was a dividend taxable as ordinary income because the instrument executed by the parties did not provide an unconditional obligation to pay a principal sum certain with interest, on or before a fixed maturity date which the court held are indicia of a debt instrument. In its decision reversing the district court, the Court of Appeals noted that, although there was no fixed maturity date, repayment was tied to a fairly certain event, i.e., the sale of the property, and guaranteed payment of an amount relative to the value of the property whereas an equity instrument would include no guarantee of dividend payments in any amount at any time. The Court of Appeals further found that the district court erred by relying on the fixed maturity date factor alone and neglecting to consider fully the several other factors which indicated bona fide indebtedness, such as the fact that taxpayer-wife had the right to enforce the contract, that her percentage of ownership and control did not change as a result of the transfer and that there was no correlation between her percentage interest in the corporation and the amount of money distributed to her.

In *Piedmont Mineral Co., supra*, the Court of Appeals affirmed the district court's finding that advances made to a corporation by its principal stockholders constituted debt for federal income tax purposes. As each advance was made, the corporation executed negotiable demand notes bearing an interest rate and secured by a deed of trust. Interest on the notes was paid as it accrued and two notes were repaid in full. The IRS disallowed the corporation's deductions for interest payments based on its determination that the advances constituted capital investments and, hence, the interest payments must be treated as a return on a capital investment. The corporation appealed the IRS determination and the federal district court ruled in its favor.

In upholding the district court's determination, the Court of Appeals found that business circumstances precluded the shareholders from acquiring a greater equity stake in the corporation and that the advances were treated as true debt. In the latter regard, the court noted that they were evidenced by demand notes executed in proper form bearing a stated rate of interest equivalent to commercial rates which was paid promptly at regular intervals. In addition, the court found that:

- Two notes had been entirely repaid before the transactions were first questioned, and a substantial amount had been set aside for further repayment.
- The notes were unsubordinated and when fully repaid a sizeable commercial loan remained outstanding.
- While the advances were in proportion to the shareholders' respective equity interests, they were not in proportion to the total interests in the corporation held by all shareholders and two other shareholders made no advances and received no financial return.
- The advances were made with little or no security but the district court found a minimal risk of business failure for the corporation and, in fact, the corporation was able to repay all the advances.

In *American Underwriters, supra*, the taxpayer and another corporation were organized by an individual owner to engage in securities transactions. The individual owner directed the trading activities of the taxpayer and the other corporation and purchased some securities of the other corporation with advances made by the taxpayer which were contemporaneously recorded as "loans" to the other corporation. None of the advances was evidenced by a written agreement or was directly secured and the other corporation did not pay interest on the advances.

The court observed that in a normal setting the absence of interest payments would indicate that the advances were equity. However, based on the owner's testimony and the additional fact that the taxpayer and the other corporation intended the advances to be short-term loans, the court found that the lack of interest payments supported a finding of equity. The court also determined that the fact that the taxpayer did not require security for the advances did not indicate equity because the taxpayer and the other corporation were commonly owned and the other corporation had a "solid history" of timely and expeditious repayment. Furthermore, the court found that an unrelated lender would have advanced funds to the other corporation in a manner similar to that employed by the taxpayer given the other corporation's history of repayment and its increased earnings.

STAFF COMMENTS

The facts of the cases cited by appellant which consider the significance of a fixed maturity date for repayment involve transfers of money to an entity, a corporation, unlike this appeal in which the entity, a partnership, made transfers to the individual partners, and did so on a pro rata basis in accordance with their relative percentage interests in the partnership. In those decisions, the courts found that, after considering all the applicable factors, the absence of a date certain for repayment, the absence of interest payments and the lack of a security requirement did not necessarily indicate a capital contribution. Staff notes that the cases involved payments made by the shareholders to the corporations for business purposes but the facts presented here do not indicate the purpose of the loans to appellant and the other partners. Also, it appears to staff that none of those cases involved facts where the transaction was initially reported as a distribution, rather than a loan, for accounting and tax purposes, and was only reported as a loan after the taxpayer was notified of an audit or examination of the transaction. At the hearing, the parties may wish to discuss whether the facts in those cases are similar to or distinguishable from the facts presented here, including the purpose or purposes for making the payments.

In addition to the fixed maturity date factor, the other factors relevant to determining whether the transfer from RHLP to appellant should be treated as a loan[3] are restated and analyzed as follows:

- *The magnitude of the withdrawal and whether a ceiling existed to limit the amount advanced;*

Appellant has presented no information as to whether a ceiling existed on the amount RHLP could advance. Here, it appears that the amount of the advance was determined solely by the amount of the proceeds from the sale of the Copacabana property.

[3] Both the issues of the effect of the stockholder's participation in the management of the corporation, and the extent to which the corporation is thinly capitalized, which are important in debt-equity cases, are irrelevant to a characterization of an advance by the corporation to a shareholder. (*Alterman Foods, Inc. v. U.S.*, *supra* at 877.)

- *How RHLP recorded the withdrawals on its books and records;*

According to appellant, the payment was recorded on RHLP's balance sheet as a distribution rather than a loan but the balance sheet was later corrected. In addition, RHLP's 2003 partnership return reported the payment as a distribution to a partner and appellant's Schedule K-1 reported the receipt of $1,668,500 as a partnership distribution. Appellant argues that the original reporting was a mistake. However, the original accounting entries and tax reporting weigh in favor of finding a distribution rather than a loan.

- *Whether the parties executed a promissory note;*

Appellant has provided an executed document titled "Demand Promissory Note" for a principal sum of $1,476,000 which recites that the principal amount is due and payable, unless demanded earlier, at least two business days prior to the date the principal amount is needed to acquire a replacement property. If possible, appellant may wish to provide evidence confirming that the Demand Promissory Note was in fact executed on or about the date appellant received the amount at issue, or at least during 2003, rather than later after respondent notified appellant that the transaction was under examination.

- *Whether interest was paid or accrued;*

The note does not provide for the payment of interest on the principal amount. However, appellant agrees to pay an amount based on a percentage of the principal if the principal is not repaid when due. Because it is common for lenders to charge and receive interest on actual loans, the Board could find that RHLP's failure to charge and collect interest for the term of the loan weighs in favor of finding that the payment was not a loan. However, staff notes that some bona fide loans are interest-only for a period, so the Board could find that this factor does not weigh against appellant.

Respondent argues that RHLP's failure to report imputed interest as provided by IRC section 7872 indicates that the payment was a distribution rather than a loan. At the hearing, respondent may wish to explain whether IRC section 7872 requires a taxpayer-lender to report imputed interest in all instances in which a taxpayer makes a loan bearing no interest or below-market interest and the consequences of failing to do so.

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- *Whether RHLP ever undertook to compel a repayment;*

There is no evidence in the record that RHLP sought repayment of the amount transferred but appellant has provided documentation to show that in 2010 he transferred to RHLP funds in excess of the amount of the purported 2003 loan. In view of appellant's payment, the evidence is unclear as to whether RHLP undertook to compel repayment or appellant transferred the funds voluntarily. Thus, this factor does not weigh in favor of either as a distribution or a loan.

- *Whether security was given for the loan;*

Appellant states that he did not pledge security for the amount tendered because the terms of the Note provided that RHLP had a right to recourse from appellant who is a high net worth individual. The lack of any security for a loan typically weighs against a finding of a loan, however security is not always required for a finding of bona fide indebtedness.

- *Whether appellant was in a financial position to repay;*

The Consolidated Balance Sheet attached to the Personal Financial Statement shows that appellant had a net worth of $25,124,076 in 2003. Most of appellant's assets in the amount of $58,617,986 appear to be investments, such as corporate equity and revenue bonds, and cash in the amount of $644,029 appears to be the only liquid asset listed. At the hearing, the parties should be prepared to discuss whether appellant had the financial ability to repay $1,476,000 upon demand at the time the Note was drawn up.

- *Whether there was any indication appellant attempted to repay;*

Appellant presented evidence that he transferred amounts totaling $1,504,000 in November and December of 2010 which he characterized as a full repayment of the loan amount of $1,476,000 and a capital contribution of $28,000. However, we note that the repayment occurred more than six years after the purported loan was made at the time when RHLP needed funds to acquire what appellant described as replacement properties. It is not clear to staff whether the amount transferred in 2010 was a repayment of a loan or whether the entire amount should be characterized as a capital contribution by a partner.

Appellant should also be prepared to present any evidence to show that a third party would make a loan of this amount on similar terms, particularly without any security and without charging interest for appellant's use of the money.

Pursuant to California Code of Regulations, title 18, section 5523.6, if either party has any additional evidence to present, it should be provided to the Board's Board Proceedings Division at least 14 days prior to the oral hearing.[4]

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[4] Exhibits should be sent to: Khaaliq Abd'allah, Appeals Analyst, Board Proceedings Division, State Board of Equalization, P.O. Box 942879 MIC: 80, Sacramento, California, 94279-0080.